Sayı: 2006- 47

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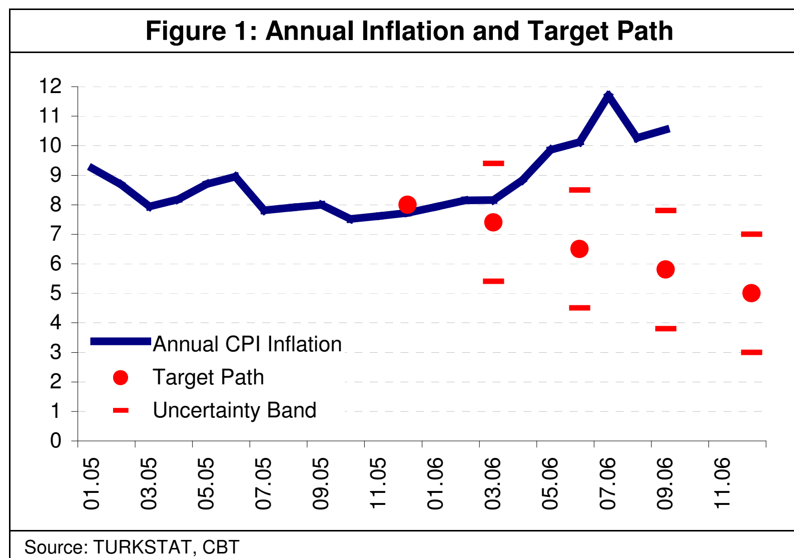
Central Bank of Turkey (CBT) adopted a formal inflation-targeting framework at the beginning of 2006. Accordingly, the end-year inflation target for 2006 was set as 5 percent, defined as the annual change in Consumer Price Index (CPI). To facilitate the accountability principle, the CBT has disclosed a quarterly path of inflation for 2006 consistent with the end-year target with an uncertainty band of 2 percentage points on both sides. In adherence with the Article 42 of the Central Bank law, the CBT committed to provide the Government with a written statement explaining the reasons for inflation exceeding the upper limit of the uncertainty band and the measures to be taken to ensure that inflation rate will return to levels within pre-established limits.

Annual CPI inflation in September 2006 was 10.55, breaching the upper limit of the uncertainty band announced for end-September 2006 at 7.8 percent (Figure 1). This open letter explains the reasons why inflation exceeded the predetermined target path by a large margin, evaluates the measures taken by the Central Bank of Turkey to bring inflation back to the target, and finally presents the medium term outlook and the horizon in which inflation converges to the medium term target. As mentioned in our policy statement titled “General Framework of Inflation Targeting and Monetary and Exchange Rate Policy for 2006” published on December 5, 2005, this Open Letter will also be presented to the IMF as part of the program conditionality.

Figure 1: Annual Inflation and Target Path



Source: TURKSTAT, CBT

The Reasons For Exceeding The Target

Before starting to present the developments in the last quarter, it would be useful to recall that in the Open Letter and the Inflation Report published in July 2006, breaching the upper limit of the uncertainty band was attributed to a combination of several supply shocks such as rising oil prices, increases in the tobacco product prices, high unprocessed food price inflation, the continued increases in the gold prices, and the portfolio shock originated from the change in global liquidity conditions. Although, the relatively strong course of the domestic demand might have been one of the factors affecting inflation, a careful analysis of the price data and capacity indicators suggested that the role of the supply factors in breaching the target, by and large, was dominant. The short-term inflation outlook has improved since the publication of the July Open Letter. Although the expected correction in unprocessed food prices has not been observed in the third quarter, the oil and other commodity prices followed a more favorable course than our baseline assumptions. This development was particularly important to contain the second round effects of the high oil prices. The rebound of the New Turkish Lira has also contributed to the short-term inflation outlook.

The accumulated impact of previous shocks has kept the annual inflation at high levels. The negative course of unprocessed food prices and the lagged impact of the exchange rate pass-through drove annual inflation up to 10.55 percent in September—a figure just about in line with our projections which stood between 10 and 11 percent for end-September inflation in the July Inflation Report.

A close look at the 9-month cumulative price increases in certain subgroups of CPI unveils the main factors behind the rise in inflation in 2006 (Figure 2). It is clear from the figure that one of the main reasons for the rise in inflation was the substantial increase in the unprocessed food prices. The figure also reveals the role of energy prices as an adverse factor in the first 9 months of 2006 inflation. Rising inflation in prices of goods excluding energy and unprocessed food can be explained by the exchange rate pass-through. The services inflation, on the other hand, exhibited a gradually declining pattern in the past three years.

Figure 2: First Nine Months Cumulative Inflation

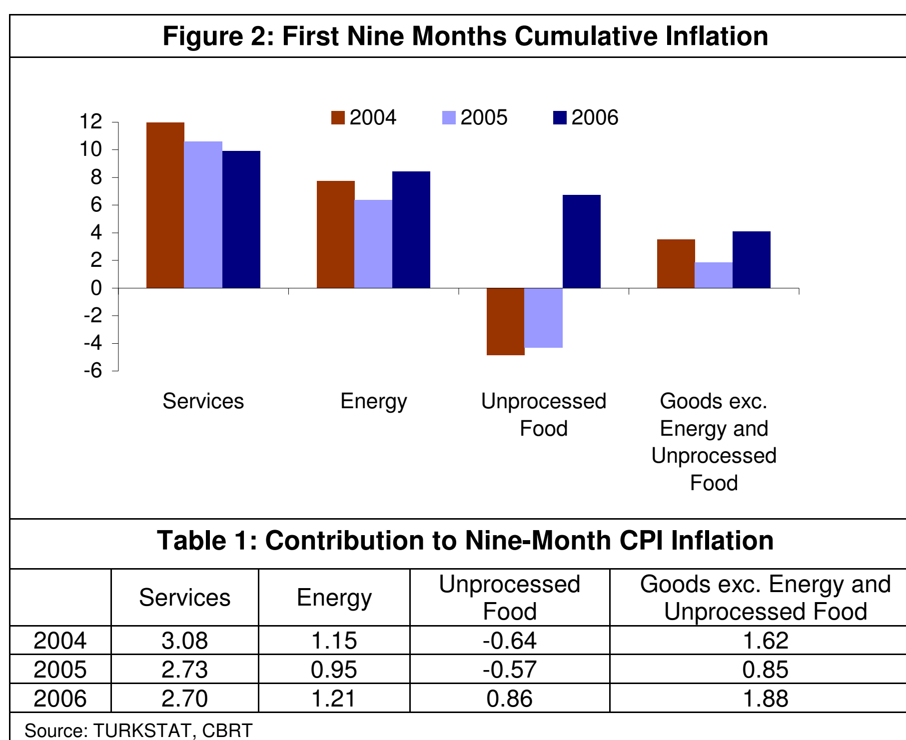


Table 1: Contribution to Nine-Month CPI Inflation

	Services	Energy	Unprocessed Food	Goods exc. Energy and Unprocessed Food
2004	3.08	1.15	-0.64	1.62
2005	2.73	0.95	-0.57	0.85
2006	2.70	1.21	0.86	1.88

Source: TURKSTAT, CBRT

The research conducted by the CBT staff suggests that the pass-through from exchange rate to consumer prices is close to 20 percent in a 5-month period. Given that the depreciation in the New Turkish Lira has been around 15 percent since April, our calculation of the cumulative pass-through impact on annual inflation is close to 3 percentage points in the May-September period. In other words, it can be claimed as a rough cut that annual inflation could have been around 7.5 percent in the absence of the sell-off in May-June period.

The first round effect of the exchange rate pass-through is almost complete. The pass-through is expected to be visible through clothing and apparel prices in October, yet remain at low levels thereafter. Accordingly, we estimate the cumulative impact of exchange rates on headline inflation to reach 3.5 percentage points until the end of the year. Assuming that the second round effects are limited, the base effect should drive annual inflation downwards starting from the second quarter of 2007.

Annual change in the most widely cited core CPI (excluding energy, unprocessed food, tobacco-alcohol and gold), denoted by H, also continued to increase during the last quarter due to lagged effects of the exchange rate pass-through, reaching 8.7 percent at the end of September. However, it should be emphasized that this is an expected outcome since a big fraction of the H index is durable goods, which is highly sensitive to exchange rate developments. Accordingly, the fact that inflation measured by H index has been rising in the last couple of months should not be interpreted as news to the monetary policy. Although the first round effects of the exchange rate pass through is largely complete, we expect core inflation figures to stay at high levels due to past cumulative effects until the second quarter of 2007.

Measures Taken to Ensure the Convergence of Inflation to the Targets

In the July Open Letter, we already mentioned that the volatility in the exchange rates, coupled with the other cost-push factors such as the strong commodity prices and rising food prices, has led to a serious deterioration in inflation expectations in May and June. Central Bank of Turkey implemented a two-pillar package as a reaction to the volatility in the financial markets and the consequent rise in inflation expectations. The first pillar of the policy response was a rate hike of 400 percentage points in June, which sent the markets a clear signal of the Central Bank's commitment to the medium-term inflation targets. It was also a manifestation of the end of the "fiscal dominance".

The second pillar of the package was to withdraw the excess domestic currency liquidity in the financial markets via deposit purchase auctions and FX sales, while raising the lending rate up by a total of 6 percentage points. By doing so, the CBT aimed to reduce the potential volatility in the markets by designing a flexible mechanism to deal with sudden shifts in the market sentiment. The plan worked well and the financial markets calmed down. Markets reacted favorably to all these decisive policy measures and the long-end of the yield curve shifted down.

In the following meeting held on July 20th, the Monetary Policy Committee (MPC) raised the policy rates by a further 25 basis points and stated that a measured tightening might be necessary to meet 2007 end-year target. By giving such a signal, the CBT aimed at containing the second round effects of the exchange rate pass-through and eliminating the mismatch between inflation expectations and the medium-term targets.

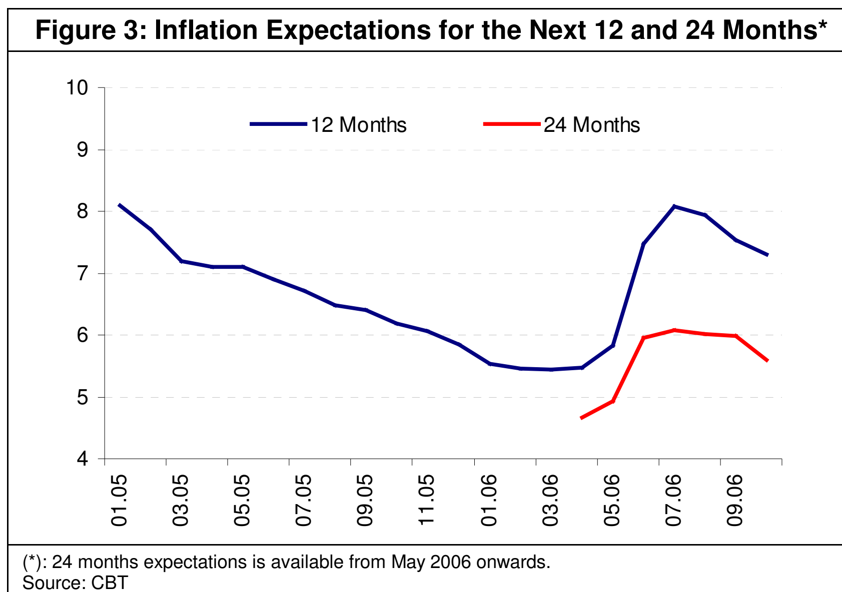
The medium-term inflation outlook has been affected by many factors since the July letter. On the positive side, new data suggested that the risks of high inflation in industrial countries have been easing. The Federal Reserve's decision, at their meeting on 8th of August to keep Federal funds rate on hold, has further mitigated the impact of the May-June sell-off on the domestic markets. This development has also reduced the risk premium, which further tightened the monetary conditions. Another positive development was the decline in commodity prices. On the other hand, domestic demand conditions have not slowed as much as expected, reflecting sooner-than-expected recovery of the confidence and partly the increase in government spending. Given these counteracting factors, the uncertainties over the transmission mechanism and over the impact of the large June-July interest rate hikes, the MPC did not change the policy rates in August and September meetings (Table 1).

The September wage award to civil servants is also likely to add to inflationary pressures, particularly in services. Accordingly, while keeping rates on hold in the October meeting, MPC stressed the need to maintain a tight policy stance in the face of continued global imbalances, high inflation expectations, and the increased risks related to services inflation.

Table 2: Monetary Policy Committee (MPC) Decisions in 2006		
Dates for MPC Meeting	**Decision on Interest Rate**	**Interest Rate**
January 23rd, 2006	No Change	13.50
February 23rd, 2006	No Change	13.50
March 23rd, 2006	No Change	13.50
April 27th, 2006	-0.25	13.25
May 25th, 2006	No Change	13.25
June 7th, 2006(1)	+1.75	15.00
June 20th, 2006	No Change	15.00
June 25th, 2006(1)	+2.25	17.25
July 20th, 2006	+0.25	17.50
August 24th, 2006	No Change	17.50
September 26th, 2006	No Change	17.50
October 19th, 2006	No Change	17.50
(1) Extraordinary		

The decisive policy measures taken by the CBT and the demonstration of its firm commitment to the medium term targets helped to contain the inflation expectations. The deterioration in medium-term expectations stopped in July. Both the 12-month and the 24-month ahead inflation expectations exhibited a declining pattern in the past 2 months (Figure 3). However, the improvement in medium term expectations was limited, possibly owing to the adaptive behavior coupled with the elevated headline inflation figures. We expect that inflation expectations will come down gradually as inflation decelerates in the medium term. The fact that currently 24-month ahead inflation expectations are significantly higher than our medium term target of 4 percent, however, necessitates a tight policy stance.

Figure 3: Inflation Expectations for the Next 12 and 24 Months*



(*): 24 months expectations is available from May 2006 onwards.
Source: CBT

Outlook For Inflation and Monetary Policy

The Background and Current Conditions

We assess that monetary policy has been tightened significantly. Implied real policy rate is 11 percent – a reasonably high figure even if it is corrected with various kinds of country risk premium measures. The longer-term interest rates such as the interest rates on government securities and consumer loans suggest even tighter monetary conditions. Other indicators, such as the slowdown in credit expansion and the monetary indicators confirm this view. Therefore, although there are uncertainties over the impact of the policy rates on economic activity, it is reasonable to assume that current financial conditions and monetary policy stance in Turkey are non-accommodative.

The tight monetary policy stance is expected to contain the inflationary pressures starting from the first quarter of 2007. The post-2001 data suggests that the impact of the real interest on the economic activity is mostly visible in 1 to 3 quarters in the Turkish economy. Indeed, there are some signs of a slowdown in the domestic demand, although not as pronounced as expected in July: The rapid credit expansion has been easing since June; the quarter on quarter consumer credit growth exhibited a significant deceleration in the third quarter of 2006 (Table 2). Automobile and housing sales registered a sharp decline in the last couple of months. Consumer confidence index dropped in June and July before it rebounded modestly. In the meanwhile, annual growth in monetary indicators displayed a noticeable decline. In sum, recent indicators suggest a considerable slowdown in the *private* domestic demand, especially on interest rate sensitive sectors such as car sales, durable goods and housing. It remains unclear, however, whether *aggregate* domestic demand will slowdown at the same pace, especially given the noticeable public spending and wage increases, and the prevailing uncertainties regarding the impact of real interest rates on demand conditions.

Table 3: Recent Developments in Consumer Loans
(3-month real percentage change)

	2005Q2	2005Q3	2005Q4	2006Q1	2006Q2	2006Q3
Consumer Loans	23.4	23.3	18.6	18.7	24.3	3.2
Housing Loans	61.9	50.6	38.1	30.8	27.2	2.6
Automobile Loans	11.7	11.4	9.9	3.2	8.9	-4.8
Other Credits	11.7	11.3	5.3	13.1	28.7	7.8
Credit Cards	8.4	6.3	6	3.2	10.6	3.8

Source: CBT

Although our projections suggest an increase in the contribution of net exports on the growth rate in the second half of the year, we expect the slowdown in the domestic demand to surpass the rise in net exports. In sum, we expect a continued growth slowdown in the next couple of quarters. The seasonally adjusted figures for the August industrial production index and the September capacity utilization rate confirm the slowdown in the growth of the aggregate demand.

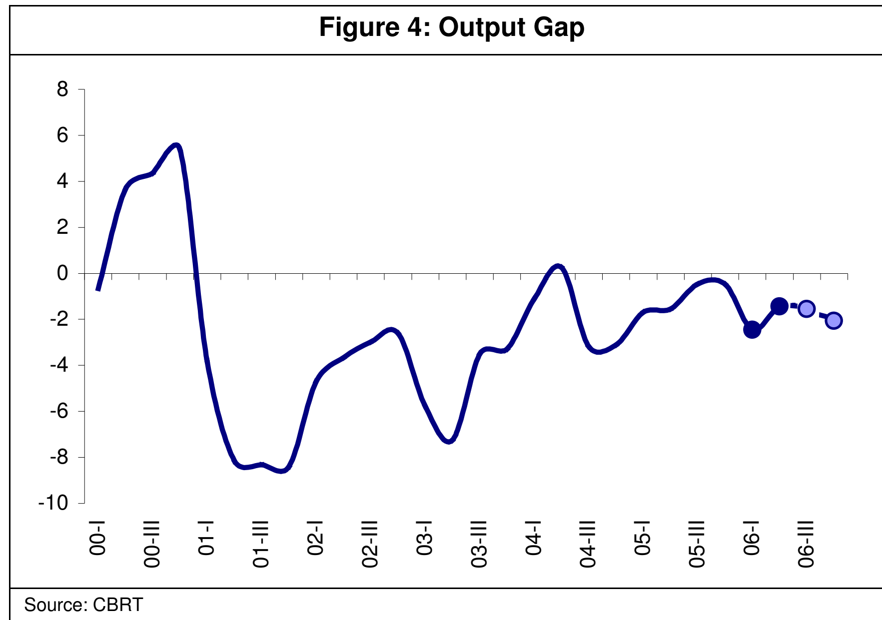


Figure 4: Output Gap

Source: CBRT

The main changes to the background of the forecast since the publication of July Inflation Report are the decline in the risk premium, output gap estimation (related in turn to stronger than expected domestic demand), the larger than envisaged civil service wage award, and the assumption on oil prices. The July inflation forecast assumed that the risk premium would remain constant. We envisaged that the decline in the confidence of the domestic agents after the May-June sell-off would induce a rapid and sharp drop in the domestic activity. However, the deterioration in global liquidity conditions turned out to be short-lived, and thus, business confidence rebounded sooner than we have expected. Consequently, although we still estimate that economic activity will operate below capacity, we now view the output gap in the second half of 2006 as slightly narrower than previously thought (Figure 4). On the other hand, the decline in the risk premium since end-July has induced a tightening in monetary conditions. That is, although the policy rates were kept constant since July, currently the risk adjusted real rate is higher than assumed in the July Inflation Report projections.

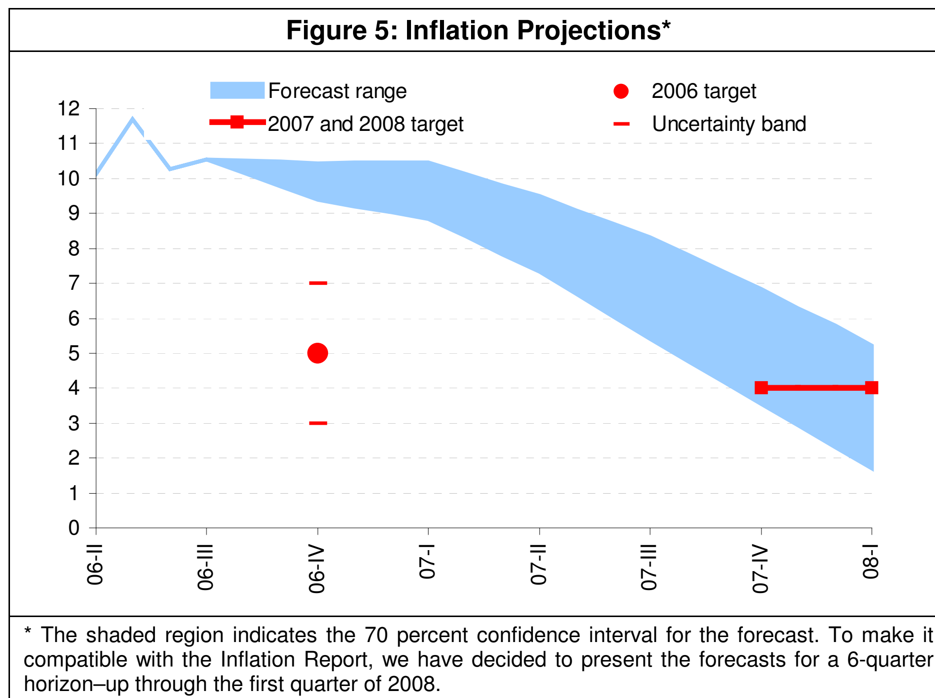
Civil service wage increases were higher than we had assumed, and could put additional pressures on services inflation in particular. Although, our assumption on oil prices was revised downwards from 70 to 60 USD per barrel, the forecasts take into account that the accumulated past increases in oil prices are most likely to yield hikes in the prices of household utilities such as natural gas and electricity, due to lagged effects. Throughout the forecast horizon, we expect that the unprocessed food prices will normalize, oil prices will remain unchanged, the world growth rate will gradually moderate, and the risk premium will stay constant.

Outlook

Our computations point out a 1-percentage point inertial impact on 2007 inflation due to the second round effects of the pass-through, which can largely be attributed to the presence of backward-looking price setting behavior especially in services inflation. We expect that the tight monetary conditions and the slowdown in the overall economic activity will ease the inflationary pressures and should limit the additional second-round effects of the exchange rate pass-through.

Against this background, we assess that bringing inflation back to the target necessitates a tight policy stance for a considerable period. Our latest forecast suggests that inflation will be between 9.2 and 10.6 percent at the end of 2006 and between 1.7 and 5.2 percent by the end of the first quarter of 2008, with 70 percent probability. Therefore, we expect inflation to converge to the target in about 6 quarters, i.e. by the end of 2008 Q1 (Figure 5).[1] The underlying policy path is an unchanged interest rate for the next four quarters and a gradual easing thereafter. It is noteworthy to stress that the policy path is conditional on the current available information, and therefore, subject to change as the new information arrives.

Figure 5: Inflation Projections*



* The shaded region indicates the 70 percent confidence interval for the forecast. To make it compatible with the Inflation Report, we have decided to present the forecasts for a 6-quarter horizon–up through the first quarter of 2008.

Risks

The first risk factor is a weaker-than-envisaged aggregate demand slowdown. This could be due to hikes in government spending or a slower-than-expected transmission mechanism of the current monetary stance. Accordingly, we will closely monitor evolving developments in the economy in light of the cumulative increase in the policy rates since June.

[1] Inflation forecast for end-2007 is between 3.5 and 6.8 percent.

The second risk factor is a deterioration in global financial market sentiment. Global liquidity is still the major factor in shaping risk appetite and volatility in financial markets. Whether it is the risk of inflation or the risk of a global slowdown, a drop in the global risk appetite might lead to another wave of portfolio shock in emerging markets, which may necessitate a policy response through its impact on expectations. It should be stressed that in June we have designed a flexible tool to cope with such possible sudden changes in the market sentiment. The current liquidity conditions in the domestic money market allow us to engineer a rapid tightening in operational policy rates between the two MPC meetings. We have already announced in our policy statements that the CBT will not hesitate to resort to this kind of tightening, should the market conditions exhibit a sharp but temporary deterioration. In case the deterioration turns out to have permanent effects on the medium term inflation outlook, the MPC will revise the borrowing rate upwards. It is worth to note that, not all the scenarios regarding the global outlook are negative. Although a slowdown in the global economic growth could have an immediate adverse impact on the domestic inflation through its impact on the risk appetite, it could mean lower commodity prices and thus lower inflation in the medium term as well.

The third risk for the inflation outlook is higher-than-expected inflation inertia, as currently manifested in the medium term inflation expectations. Given that we plan to bring inflation down from 10 percent to 4 percent in a fairly short period of time, the degree of stickiness in services inflation emerges as a major risk to our forecast, especially if one considers the recent real increase in civil service wages. The inflation in services (apart from the relatively low productivity growth in this sector) displays a strong backward looking component, and thus it usually lags behind the headline inflation under a disinflation episode. Currently, the annual percentage change in services price index is around 12 percent. Our projections suggest that the moderation in domestic demand may drive services inflation down to as low as 9 percent next year—contributing 2.5 percentage points to the headline inflation in 2007. This means the goods inflation has to stay close to 2 percent, for the headline inflation to adhere to the 4 percent target at the end of 2007.

Conclusion

Monetary policy has been tightened significantly since mid-June. This non-accommodative monetary stance is expected to slow demand and bring inflation down to its target by the end of 2008 Q1. Although the accumulated impact of the various cost-push shocks combined with the continued exchange rate pass-through has kept inflation at high levels, the policy measures we have taken in June 2006 have been successful in containing further deterioration in medium term inflation expectations. However, there are significant upside risks to our baseline inflation projection. Materialization of such risks will lead the CBT to further tighten the policy stance by raising policy rates. That is why we will conduct monetary policy with a tightening bias in the period ahead. In other words, monetary policy will stay more attentive to adverse developments than favorable developments regarding inflation outlook. This approach reflects our commitment to achieving the medium term inflation target.

Against this backdrop, we decided jointly with the government to keep the 4 percent target for 2007. The volatility in the financial markets in May-June period in Turkey, by all means, can be considered as a significant shock. Some countries have chosen the strategy to change their targets when they were faced with similar shocks (See Brazil 2003, for example). Although our baseline projections suggest that it may take around 6 quarters to bring inflation back to the target, we see a considerable chance that inflation can be brought close to the 4 percent target at the end of 2007, particularly given our tightening bias. More importantly, we believe that changing the end-2007 target at this stage could not only have adverse implications for expectations and wage setting process for 2007 but also undermine the credibility of future policy commitments.

High primary budget surpluses have supported the disinflation process to a large extent during the past years. Maintaining and advancing the gains achieved thus far would benefit from the continuation of the reforms related European Union accession process, and the implementation of structural reforms, which will ensure the sustainability of fiscal discipline in the long run.

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